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LETTER OF TRANSMITTAL

TO THE MEMBERS OF THE BUDGET COMMITTEE:

Transmitted herewith for the use of the Members of the Budget Committee and other Members of the Congress is a study entitled, "The International Economy and the Federal Budget." This study outlines the implications of the present slowdown in the international economy for the domestic economy and the Federal budget in fiscal year 1978 and beyond.

The study indicates that the increase in the world price of oil and the resulting large trade surplus of the oil exporting countries has been, and will continue to be, an important source of the world-wide increase in unemployment and inflation. Further increases in the oil price will drain additional income from oil-importing countries, worsen the debt problem of the weaker economies, and reduce demand for American exports.

The export sector is now 10 percent of our GNP and as large as the investment sector of the U.S. economy. Slower growth of U.S. exports will mean that a larger fiscal stimulus and budget deficit will be required if our domestic economic goals are to be reached.

The paper suggests that the current situation requires internationally coordinated policies to maintain world-wide demand and reduce dependence on OPEC oil. Two essential elements in this policy are: (1) expanded support for the weaker economies as they adjust to the new energy situation and (2) fiscal policies that lead to a resumption of above-trend economic growth in the United States and in the other strong economies.

This report was prepared by Van Doorn Ooms and Arnold Packer of the Budget Committee staff.

Nothing in this study should be interpreted as representing the views or recommendations of the Budget Committee or any of its individual Members.

With best wishes, I am

Sincerely,

EDMUND S. MUSKIE,
Chairman.

ACKNOWLEDGMENTS

The authors wish to acknowledge the helpful comments on earlier versions of this paper by numerous staff and professional colleagues. In particular we would like to thank Colin Bradford, who helped us think through the problem, and Douglas J. Bennet, who helped us make it intelligible. The remaining errors are our own.

I

SUMMARY

Congressional deliberations on the fiscal 1977 budget and President-elect Carter's campaign emphasized the relationships between the budget and domestic economic goals. Economic growth of 5.5 to 6 percent is required over the next 4 years to reach relatively full employment in 1980. Responsible price and wage behavior will be needed to reduce inflation to about 4 percent. Fiscal discipline must be maintained to hold the size of the Federal Government to 20–21 percent of full employment GNP. Finally, high productivity in a growing private sector is needed to generate the revenues required to balance the budget.

Each of these domestic goals can be jeopardized by adverse international developments, however, because of the increased importance of exports in U.S. total demand. In 1976 exports amounted to $163 billion, almost 10 percent of U.S. GNP of $1.692 billion.[1] The dollar value of exports is approximately equal to that of business fixed investment and 2½ times as large as residential construction. Achievement of our domestic growth and employment goals and the reduction of the Federal budget deficit will require vigorous export demand generated by a healthy world economy.

The U.S. interest in a healthy international economy, however, is not limited to concern over the domestic economy and a balanced U.S. budget. International political stability is perhaps of even greater importance. The economic problems now occurring in the United Kingdom, Italy, France, Portugal, Spain, and other countries, could have adverse political consequences for NATO, quite apart from possible costs to the U.S. budget in terms of economic or military assistance. Economic progress and political stability in the developing countries depend even more strongly upon a sound international economy.

IMPACT OF OPEC PRICE INCREASE

The health of the world economy has deteriorated since the sudden increase in the world oil price by the Organization of Petroleum Exporting Countries (OPEC) cartel in 1973–74. The continuing OPEC foreign sector surpluses[2] resulting from the increased oil price tend to contract world spending, income and employment.

This contractionary tendency occurs for several reasons. First, the increase in oil prices drains off purchasing power from the oil importing countries. Second, policymakers are hesitant to provide adequate fiscal and monetary stimulus in the face of the inflation related

[1] Full-year estimates based upon the data for the first 3 quarters of 1976.

[2] *Foreign sector surpluses* (or deficits) refers to the current account surplus (or deficit) in the balance of payments. The current account surplus is the difference between a country's receipts and payments for goods, services, and private transfer payments.

to rising energy prices. Third, several OPEC exporters spend only a small part of the enormous income they receive from oil importers. Finally, the lending of these unspent surplus funds produces an international debt problem for some non-OPEC countries; this will reduce their growth and import demand, again reducing world spending and U.S. exports. The 1975 world recession was closely related to the OPEC surplus, as is the present international slowdown in economic growth.

ALTERNATIVE STRATEGIES

These contractionary effects can be offset only if compensatory policies to stimulate demand are undertaken by non-OPEC countries. Thus, if the United States chooses to pursue its growth and employment goals by offsetting weaker export demand with domestic fiscal stimulus, it can do so only by incurring larger budget deficits. If the United States attempts to offset the entire shortfall in world demand single-handedly, its budget deficits will be extremely large.

A preferable strategy would coordinate domestic and international economic policies and ensure that compensatory increases in demand also take place in other countries. Such a coordinated policy would require more expansionary economic policies in Germany, Japan, and other strong economies, as well as in the United States. It would also require increased international financial assistance to the weak economies, allowing them to maintain or renew their economic growth. These weaker economies will have to adopt policies that direct this financial assistance to productive investments, thereby assuring the international community that the debt will ultimately be repayed.

This coordinated policy would produce a larger demand for U.S. exports than the option that relies exclusively on domestic stimulus. It would make it possible to attain our domestic growth and employment goals with a declining budget deficit, while simultaneously assisting economic recovery in other countries.

An internationally coordinated policy to reduce dependence on OPEC oil is the only way to eliminate the OPEC trade surpluses and stop the accumulation of debt by non-OPEC countries. But this is a long-run objective that will take some years to accomplish. In the meantime, the strong countries must undertake the domestic and international economic policies required to forestall a new recession.

II

THE IMPORTANCE OF THE INTERNATIONAL ECONOMY TO U.S. ECONOMIC AND BUDGETARY GOALS

The U.S. economy has been large enough throughout the postwar period to profoundly affect our neighbors. It used to be said that when the U.S. sneezed, Europe caught pneumonia. Only recently, however, have we become highly vulnerable to foreign economic ailments. Foreign demand has now become a major determinant of income and employment in the U.S. Table 1 shows the increasing importance of exports in total U.S. demand during the postwar period. Exports of goods and services are now almost 10 percent of GNP; for goods alone

the share is 12.5 percent. Exports are now as large as business fixed investment and more than 2½ times as large as expenditures on housing.

This large export sector has a profound influence upon growth and employment in the American economy. If exports fail to expand vigorously, it will be impossible to return to full employment unless we apply enough fiscal and monetary stimulus to the economy to compensate for this reduced world demand for U.S. goods.[3] *Growth in the international economy, which provides the demand for our exports, is thus essential to the attainment of our domestic economic and budgetary objectives.*

TABLE 1.—COMPOSITION OF U.S. AGGREGATE DEMAND, 1950–1976

	Percent				1976 value (billions) [1]
	1950	1960	1970	[1] 1976	
Exports of goods and services	4.9	5.5	6.4	9.6	$163
Expenditure on domestic production	95.1	94.5	93.6	90.4	1,529
Total GNP	100.0	100.0	100.0	100.0	1,692
Of which:					
Residental construction	6.8	4.8	3.6	3.5	60
Business fixed investment	9.5	9.4	10.2	9.5	160

[1] Full-year estimates based upon the data for the 1st 3 quarters of 1976.

Consider the following illustration. Exports grew at an average rate of 11 percent during the 1954–74 period. If export growth ceased during the next 4 years, instead of growing at 11 percent, total demand in the United States in 1980 would be $84 billion lower, other things being equal. If our growth and employment goals were to be realized through increased fiscal stimulus, this export shortfall would have to be made up by $84 billion of tax cuts or additional Federal spending.[4] The effect on the budget deficit could be even larger than $84 billion, however, because exports generally come from the higher productivity sectors of our economy. Federal revenues are generated by high productivity workers who generally receive high salaries and create profits for their employers. If we were to shift workers from the export sector to public service employment, for instance, this would decrease revenues as well as increase Government expenditures. *Export growth is therefore a crucial element in the strategy of balancing the budget by 1981.*

III

THE EFFECTS OF OPEC FOREIGN SECTOR SURPLUSES ON THE INTERNATIONAL ECONOMY

The growth of U.S. exports depends upon the expansion of our trading partners' capacity to import. Their capacity to import depends upon their export earnings and their willingness and ability to borrow from abroad. The four-fold increase in the OPEC oil price

[3] Different export industries may be affected differently by changes in foreign demand. Weak foreign demand for agricultural exports will tend to have relatively small direct effects on employment, but large effects on income; the opposite will tend to be true of industrial exports.

[4] The required tax cut would in fact be larger than $84 billion because some portion of the tax cut would be saved rather than spent by the private sector.

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in 1973–74 produced a profound imbalance in the world economy which reduces the ability of other countries to expand their imports from the United States and from each other. This happens because the higher OPEC oil price means lower incomes and increased foreign debt in non-OPEC countries.

A. OPEC Foreign Sector Surpluses and the Creation of International Debt

The price of OPEC oil was $2.30 per barrel in mid-1973 before the Arab embargo. The OPEC nations presently export approximately 10 billion barrels of oil annually at a price of $11.50 per barrel. These sales produce annual revenues of about $115 billion, approximately $80 billion more than the 1973 level. While many OPEC countries such as Iran and Indonesia have expanded their import spending rapidly enough to use up most of these increased revenues, the oil producers of the Arabian peninsula (Saudi Arabia, Kuwait, and the United Arab Emirates) spend only a small portion of their great oil revenues. OPEC as a whole, therefore, has a large surplus of export revenues over import expenditures.

These OPEC foreign sector surpluses will continue until they are eliminated by a levelling off or decline in OPEC revenues and rising OPEC imports. These changes will eventually come about as a result of energy conservation by oil importers, the emergence of new non-OPEC energy sources, and economic growth within OPEC. Such developments require time, however, and the adjustment cannot take place in the immediate future. Thus, over the next 2 or 3 years, the OPEC foreign sector surplus will be $30 to $50 billion annually. The higher figure is more likely if the world economy and oil imports grow rapidly; if efforts to reduce oil imports remain weak; and if the growth of OPEC imports, including military hardware, slows down. These $30 to $50 billion OPEC surpluses have two major implications for non-OPEC countries.

First, one country's surplus must be another country's deficit. *All non-OPEC countries together must therefore have an annual foreign sector deficit equal to the OPEC surplus.* The non-OPEC countries consequently cannot all bring their foreign sector payments into balance. If one non-OPEC country's deficit is to be smaller, another's must be larger.

Second, for every lender there must be a borrower. For example, a $30 billion OPEC surplus means that OPEC is lending $30 billion of oil exports to the non-OPEC countries and accumulating $30 billion of claims against them. Therefore, *all non-OPEC countries together will be increasing their foreign debt to OPEC annually by the amount of the surplus. The total debt must grow as long as the OPEC surpluses continue.*

The borrowing from OPEC can be done directly, as when the OPEC surpluses are invested in U.S. Treasury bills, loaned to Pakistan, or used to buy 10 percent of Fiat. More often they are made indirectly, with OPEC depositing its excess revenues in international banks, which in turn lend them to countries in deficit such as the United Kingdom, Italy, or Brazil.

B. How the OPEC Surpluses Directly and Indirectly Reduce World Demand

The higher OPEC oil price redistributes about $80 billion of world income each year from oil importers to the OPEC oil exporters. Most of this income would have been spent on domestic goods or imports had it still belonged to the oil-importing countries. *Because the OPEC oil exporters will not spend $30 to $50 billion of their higher income, world demand will tend to be lower. This reduction in demand will lower incomes, slow growth, and raise unemployment throughout the world unless compensatory policies are adopted to raise spending elsewhere.*

This direct effect of the OPEC surplus on spending was evident in the recent recession. In 1974 the OPEC countries ran a $67 billion foreign sector surplus, which suddenly reduced world demand by about that amount. The result was an international recession which reduced incomes, oil imports and OPEC earnings. This fall in earnings and increased OPEC imports reduced the OPEC surplus to $35 billion in 1975. This contractionary effect was accompanied by the sharp impact of higher energy prices, which accelerated the existing inflation. The United States and some other industrial countries attempted to combat this additional inflation with restrictive monetary and fiscal policies. These policies reinforced the contractionary effect of the OPEC surpluses rather than compensating for it, and the recession was exceptionally severe.

HOW THE SMALLER ECONOMIES ACCUMULATED DEBT

The present distribution of international debt reflects the economic policies, and resulting foreign sector deficits, which the non-OPEC countries undertook during the 1974–75 recession. The United States, Germany, and Japan adopted relatively restrictive fiscal and monetary policies which lowered incomes, sharply curtailed imports, and produced collective foreign sector surpluses of $11 billion in 1974 and $23 billion in 1975. These large economies thus fell into recession and avoided accumulating debt to OPEC. The recession in the industrial world increased the debt of other non-OPEC countries, however, since it reduced demand for their exports and forced them to borrow heavily to finance imports. The smaller industrial countries and the developing countries adopted more expansive policies, in varying degrees, as they found greater unemployment and lower growth to be socially and politically unacceptable. The developing countries continued to grow at about 4 percent during 1975 when the industrial economies' real output fell by 1.5 percent. These smaller economies ran foreign sector deficits of $55 billion in 1975, and accumulated debt accordingly, to balance the temporarily reduced OPEC surplus of $35 billion plus the United States-Germany-Japan surplus of $23 billion.[5] In doing so they played an important stabilizing function. *Had the smaller economies "prudently" abstained from borrowing and adopted policies to reduce their imports, the recession would have been much worse for all countries.*

[5] The difference between these $55 billion of deficits and $58 billion of surpluses is accounted for by trade with the Sino-Soviet bloc and the statistical discrepancy, as shown in Table 2, page 8.

THE INTERNATIONAL DEBT PROBLEM

This concentration of foreign sector surpluses in the giant economies and deficits in the developing and smaller industrial economies led to "the international debt problem." A disproportionate amount of debt was accumulated by these weaker economies, who now hold some $150–200 billion of international debt. Moreover, this debt has increasingly become held by international banks in relatively short maturities at commercial interest rates. The prospective difficulty of paying the interest and principal on this debt has eroded the creditworthiness of many of these countries and has made continued debt accumulation by them more difficult. Some of them have now reached the limits of their borrowing capacity and therefore of their ability to increase imports and run foreign sector deficits. *The foreign debt created by the OPEC surpluses will reduce world demand if it induces or forces countries to sharply reduce their import growth.* Debtor countries will become unwilling or unable to increase their borrowing and to undertake the additional compensatory spending required to offset the OPEC surplus. They will also lower import spending by introducing restrictive trade policies. If these spending increases do not take place, the result will be insufficient world demand, slower growth, and higher unemployment.

SIGNS OF CONTRACTIONARY EFFECTS

The international economy is now showing signs of these contractionary effects of the OPEC surpluses and debt creation. Austerity programs have been announced in the United Kingdom, Italy and France to reduce the growth of income and imports. Sharp currency depreciations have taken place in the United Kingdom, Italy, Spain, Mexico, and Australia. Direct restrictions on imports and foreign exchange transactions are appearing again in Europe and becoming more prevalent in the developing countries. These policies contract world demand and are contributing to the present international slowing of growth. If the slowdown continues, additional countries will be likely to adopt such policies and push the slowdown into recession.

C. How the OPEC Surpluses Increase National Budget Deficits

We have seen that the contractionary effect of the OPEC foreign sector surplus will normally require additional fiscal stimulus in the non-OPEC countries if they are to maintain growth and employment at satisfactory levels. This additional fiscal stimulus will of course increase a country's budget deficit. At the same time, by raising the rate of economic growth and the demand for imports, it will increase the foreign sector deficit, other things being equal. *Thus, the OPEC foreign sector surplus tends to generate simultaneous budget deficits and foreign sector deficits in oil-importing countries which use fiscal policy to maintain growth.* These budget deficits are one way to borrow the OPEC surplus and reinject those funds into the world's spending stream. For example, the United States can finance a Federal budget deficit by selling Treasury bills to the OPEC countries or to banks that hold OPEC deposits.

In principle this compensatory increase in domestic demand could be provided by a sufficiently expansionary monetary policy. The monetary authorities, it is said, could allow the money supply to grow rapidly, thereby lowering interest rates and increasing domestic demand for investment goods and housing. If investment demand could be raised sufficiently, there would be no need for a budget deficit.

However, there are several reasons why monetary stimulus is unlikely to be a practical alternative to fiscal stimulus in the next few years, although an accommodative monetary policy will be necessary. First, the present inflation means that very high rates of growth in the nominal money supply will be required to have a significant expansionary effect. An 11-percent rate of growth in the broadly defined money stock would be needed now to have the same impact that the 7 percent rate of the 1960's had 10 years ago. Judging from recent experience, it does not appear likely that the monetary authorities would be prepared to increase the money supply continually at what are very rapid rates by historical standards, even if it were desirable to do so. For this reason, in-flows of capital from OPEC are also unlikely to affect the money supply, interest rates, or investment in the United States in a significant way: the in-flow will tend to be neutralized if the Federal Reserve pursues its targets for monetary growth.

Second, it is unlikely that a moderately more expansive monetary policy would by itself have much effect on investment demand in the current economic environment. This is because the demand for investment goods will remain relatively insensitive to interest rates until we return to higher rates of capacity utilization. Monetary policy will be more effective in stimulating the private economy when we return to lower inflation and unemployment than it will be in the next few years.

IV

A PROJECTION OF INTERNATIONAL SLOWDOWN

A. The Current Policy Outlook: A Failure to Reach Domestic Goals

Recent news releases have called attention to the Organization for Economic Cooperation and Development (OECD) forecasts of sharply reduced growth in the United States and OECD as a whole in 1977. U.S. growth is now forecast at 4.7 percent and that for the rest of the OECD at 3.5 percent, giving a 4 percent rate for OECD as a whole. Table 2 presents a projection of the international and domestic implications for 1977 and 1978 of such a slowdown in international growth. While the numbers in Table 2 (and others to follow) are subject to considerable uncertainty, they are consistent with the general pattern of international change assumed. The argument rests on the direction and pattern of change of the variables rather than their precise level.

The projection assumes that "current policies" are followed in the United States and that the 4 percent OECD growth forecast for 1977 will materialize because many developing countries and weaker industrial countries will be forced to reduce the rate of increase in their

debt. They will, therefore, slow their import growth through contractionary policies, currency devaluation, and restrictions on trade. These policies will have a further depressive effect on real growth in 1978, which is assumed to fall to 3.5 percent in the United States and 2.5 percent in other OECD countries.

TABLE 2.—PROJECTION OF INTERNATIONAL SLOWDOWN [1]

[In billions of dollars]

	Actual [2]		Projected [3]		
	1974	1975	1976	1977	1978
Foreign sector balances: [4]					
OPEC surplus [5]	67	35	40	40	35
Developing countries [6]	−29	−37	−30	−28	−25
Developed countries [7]	−24	5	−10	−12	−10
United States	3	16	2	−5	−10
Germany and Japan	8	7	11	10	10
Other developed countries	−35	−18	−23	−17	−10
Sino-Soviet bloc and statistical discrepancy [8]	−14	−3	0	0	0
Results for U.S. economy:					
Net exports (NIA) [9]	7.5	20.5	7	0	−5
Real export growth (annual rate) [10] (percent)	5.7	−2.1	4.7	2.0	1.0
Real GNP growth (annual rate) [10] (percent)	−4.1	2.3	5.3	4.5	3.5
Unemployment rate [11] (percent)	6.7	8.5	8.0	7.6	7.6

[1] Numbers in this and subsequent tables should be considered as orders of magnitude only, as the statistical reporting of international current account balances is very weak. Competent projections of the 1976 OPEC surplus, for instance, differ by $10 billion.

[2] IMF, "Annual Report 1976" and "International Financial Statistics," August, October 1976.

[3] The OECD forecast of 4.7 percent U.S. growth for 1977 has been marked down to 4.5 percent to reflect the current CBO forecast of 4.3 percent.

[4] Balances on goods, services, and private transfers.

[5] Includes Oman, which is not a member of OPEC. The projection assumes an oil price increase of 5–10 percent at the beginning of 1977 and a similar increase at the beginning of 1978. It also assumes 1976 OPEC sales of 10.3 billion barrels at a price of $11.50 per barrel. OPEC is taken to be the residual supplier of energy to the world market in 1977 and 1978. Total energy demands, and supplies from non-OPEC sources, have been projected on the basis of estimates made by international organizations, private agencies, and private banks. OPEC imports are assumed to grow at 15 to 18 percent annually in 1977 and 1978, depending on the growth of OPEC export revenues.

[6] Includes all countries except developed countries (see below), OPEC and the Sino-Soviet bloc.

[7] OECD plus South Africa, Israel, Yugoslavia, Cyprus, and Malta.

[8] The statistical discrepancy varies widely from year to year. It depends upon statistical coverages and lags in reporting various trade and financial flows. There is roughly a balance between the current account deficit of the Sino-Soviet bloc and the positive statistical discrepancy, however, so the net balance of the two is projected here as zero.

[9] Net exports (NIA) differ from the current account balance in that they exclude private transfers and interest paid to foreigners on U.S. Government debt. These items add approximately $5 billion to the current account deficit.

[10] 4th quarter over 4th quarter rates estimated from the OECD 1977 forecast of semi-annual rates and the assumed 1978 rates described in the text.

[11] 4th quarter. Calculated on the assumption that 3½ percent real growth is required to hold the unemployment rate constant, and that for each 1 percent deviation from 3½ percent growth the unemployment rate will change by 0.4 percent per year.

The top half of the table shows the development of the OPEC and other foreign sector balances consistent with these assumptions. The OPEC surplus declines because of reduced growth in oil exports and continued rapid growth in OPEC imports. The foreign sector deficit of the developing countries falls from $30 billion in 1976 to $25 billion in 1978, and that of the smaller developed economies from $23 billion to $10 billion, as contractionary macroeconomic policies and restrictive trade policies are adopted. The rate of U.S. growth slows less drastically than that of other economies. U.S. import growth therefore slows less than that of exports, and this shows up as a decline in the U.S. foreign sector balance. Note that two optimistic assumptions lie behind this projection. The OPEC price increase of 5–10 percent in January, 1977 will not be followed by another increase later in the year; and the weak economies will be able to borrow about another $80 billion over the next 2 years, despite the uneasiness over the cur-

rent level of debt in these countries. *If these assumptions are not met, the slowdown will be more severe.*

The bottom half of the table shows some important effects of the international slowdown on the U.S. domestic economy. The net export balance simply reflects the foreign sector balance according to adjustments explained in the notes. The decline in export growth as world demand slows results in an unemployment rate that remains well above 7 percent through 1978. *Such low growth would mean little progress in reducing the Federal deficit in fiscal 1978.*

B. Implications of the Slowdown for Foreign Economic Policy Goals

While this 1978 outcome will clearly make the realization of our 1980–81 domestic goals impossible, it may also mean the failure of our foreign economic policy.

Slow growth in the weaker industrial countries and weak export markets will increase competitive exchange rate and restrictive trade policies, even though such "adjustment" policies will collectively prove self-defeating. Quite apart from the strictly economic effects, this outcome can threaten the Western Alliance, since continued stagnation in the weak economies of Western Europe and increased tensions among them may have dramatic political repercussions.

EFFECTS ON DEVELOPING COUNTRIES

The effects on the developing countries may be even more severe because of the fragility of their economic and political structures. For many of them there is very little margin, either economically or politically, for accommodation to the lower imports and slower growth implied by the "belt-tightening" policies recommended by Secretary Simon at the recent Manila meetings of the IMF and World Bank. *Consequently, the developing countries may also experience increased political instability along with economic stagnation and continued poverty.* This is likely to be accompanied by political repression, controls on trade and investment, and default on debt. One might then expect more strident demands for general debt moratoria, expropriation of investments, and other obstacles to a liberal international economic order. The threat of such actions, by itself, may lead the private banks to reduce their overseas exposure, instead of increasing it as assumed in Table 2. *A substantial contraction of private credit could lead to a severe recession.*

INCREASED ARMS EXPORTS

One of the most unfortunate by-products of the OPEC surpluses since 1973 has been the rapid escalation of arms exports to the Middle East from the industrial countries. Arms imports into the Middle East, measured in constant 1973 prices, rose from about $1 billion per year in the early 1970's to nearly $3 billion in 1975. The United States provided a large share of this increase and doubled its weapons exports to all developing countries from $0.9 billion to $1.8 billion over the same period. Moreover, because of long delivery times, these export data do not disclose the magnitude of the problem. During the fiscal

years 1966 to 1972. U.S. export orders of weapons, equipment, and related services from OPEC averaged $0.3 billion annually; in fiscal years 1974 and 1975 the average was $5.5 billion. At the end of fiscal 1975 the United States had a balance of $12.6 billion of unfilled arms orders from OPEC, in addition to $3.4 billion with other third-world countries.

A weak international economy can only exacerbate this problem. With export markets soft, the major arms exporting nations will be unlikely to resist pressures to increase arms sales to the Middle East. Even though the capacity of surplus countries such as Kuwait to absorb arms is limited, their oil revenues may be donated or lent to other OPEC countries whose desire for weapons is greater. *Arms sales, by reducing the OPEC surplus, have become an economic stabilizer; they may, however, destabilize the international system politically.*

V

RESTORING GROWTH WITH DOMESTIC STIMULUS ONLY: LARGER BUDGET DEFICITS

Although the U.S. economy increasingly depends on the world economy, domestic policy instruments can still offset the international contractionary forces which depress the demand for U.S. exports. In practice this means the application of additional fiscal stimulus, and the acceptance of correspondingly large budget deficits, to provide the domestic demand required to replace the missing exports. This policy alternative is illustrated in Table 3, where it is assumed that the United States applies enough fiscal stimulus to produce 6 percent growth during 1977 and 1978, while policies in other countries remain essentially unchanged. This would require about $15 to $25 billion of additional stimulus in each year. The 6 percent growth would lower the unemployment rate to 6 percent by the end of 1978.

EFFECTS ON OTHER COUNTRIES

A more stimulative U.S. domestic policy would also provide some benefits for other countries. Part of this increased fiscal stimulus would be transmitted through our increased imports to the international economy. This would, to some degree, raise other countries' export earnings, their borrowing capacity, and their ability to import. It would therefore reduce the likelihood that the debt-burdened countries would adopt restrictive trade and expenditure policies to reduce their current account deficits. It would not, however, provide enough stimulus to restore a high rate of growth throughout the world economy, since no additional self-generated increases in demand would be taking place in other countries.

The Congressional Budget Resolution envisioned a deficit of $50 billion for fiscal 1977. The economy has weakened since then; CBO estimates that revenues will be $5 to $10 billion less and the deficit correspondingly higher. President-elect Carter and the Congress wish

TABLE 3.—DOMESTIC POLICY OPTION

[In billions of dollars]

	1976	1977	1978
Foreign sector balances: [1]			
OPEC surplus [2]	40	42	40
Developing countries [3]	−30	−28	−25
Developed countries [4]	−10	−14	−15
United States	2	−8	−20
Germany and Japan	11	11	11
Other developed countries	−23	−17	−10
Sino-Soviet bloc and statistical discrepancy [5]	0	0	0
Results for U.S. economy:			
Net exports (NIA) [6]	7	−3	−15
Real export growth (annual rate) [7] (percent)	4.7	2.5	1.5
Real GNP growth (annual rate) [7] (percent)	5.3	6.0	6.0
Unemployment rate [8] (percent)	8.0	7.0	6.0

[1] Balances on goods, services, and private transfers.

[2] Includes Oman, which is not a member of OPEC. The projection assumes an oil price increase of 5–10 percent at the beginning of 1977 and a similar increase at the beginning of 1978. It also assumes 1976 OPEC sales of 10.3 billion barrels at a price of $11.50 per barrel. OPEC is taken to be the residual supplier of energy to the world market in 1977 and 1978. Total energy demands, and supplies from non-OPEC sources, have been projected on the basis of estimates made by international organizations, private agencies, and private banks. OPEC imports are assumed to grow at 15 to 18 percent annually in 1977 and 1978, depending on the growth of OPEC export revenues.

[3] Includes all countries except developed countries (see below), OPEC and the Sino-Soviet bloc.

[4] OECD plus South Africa, Israel, Yugoslavia, Cyprus, and Malta.

[5] The statistical discrepancy varies widely from year to year. It depends upon statistical coverages and lags in reporting various trade and financial flows. There is roughly a balance between the current account deficit of the Sino-Soviet bloc and the positive statistical discrepancy, however, so the net balance of the two is projected here as zero.

[6] Net exports (NIA) differ from the current account balance in that they exclude private transfers and interest paid to foreigners on U.S. Government debt. These items add approximately $5 billion to the current account deficit.

[7] 4th quarter over 4th quarter rates estimated from the OECD 1977 forecast of semi-annual rates and the assumed 1978 rates described in the text.

[8] 4th quarter. Calculated on the assumption that 3½ percent real growth is required to hold the unemployment rate constant, and that for each 1 percent deviation from 3½ percent growth the unemployment rate will change by 0.4 percent per year.

to put the economy back on a 6 percent growth path. If the international demand assumed in Tables 2 and 3 is correct, and the usual fiscal multipliers apply, this will require a fiscal stimulus of $15 to $25 billion. *This means a deficit of over $70 billion for FY 1977.*

Additional fiscal stimulus would be required in fiscal 1978 to offset the deterioration in the net export balance (which falls from −$3 billion in 1977 to −$15 billion in 1978). This additional stimulus would offset much of the reduction in the budget deficit that might be expected from an improving economy. *Thus, the Federal deficit would remain at the politically unattractive level of $70 billion or more if U.S. fiscal stimulus is to be the exclusive means of maintaining domestic growth. If the U.S. alone provides the compensatory demand to offset the contractionary effect of the OPEC surplus, large budget deficits will be required so long as large OPEC surpluses exist.*

This must not be interpreted to mean that the United States can obtain the necessary domestic expenditure by substituting restrictive trade policies for fiscal stimulus. Such policies will certainly result in protective or retaliatory policies by the EEC, Japan, and other countries as they attempt to protect their own trading positions. This would lower American exports and destroy American jobs. *Competitive trade restrictions and exchange rate policies by the major countries will lower world demand, growth, and employment and make everyone worse off. Internationally coordinated policies are necessary in an interdependent world economy.*

VI

RESTORING GROWTH WITH COORDINATED INTERNATIONAL AND DOMESTIC POLICIES: LARGER FOREIGN DEMAND AND SMALLER BUDGET DEFICITS

There is no reason why the United States alone must bear the responsibility for maintaining international demand through expansionary policies, as the "domestic-stimulus-only" option implies. Other strong industrial economies—notably Germany and Japan—must share the responsibility to provide the fiscal and monetary stimulus that world economic recovery requires. *More economic stimulus in Germany and Japan means that less fiscal stimulus and smaller budget deficits will be required in the United States.*

There is also no reason why debtor countries should not continue to borrow, and run foreign sector deficits, if these borrowed resources are used to expand their economic capacity in a way that will enhance their ability to repay this debt. Borrowing for productive investment by the debtor countries will enlarge their import capacity and raise the demand for U.S. and other countries' exports. *More demand abroad means that less will be required at home; larger imports by the developing economies and other debtor countries also lower the requirements for fiscal stimulus and budget deficits in the United States.*

COORDINATING INTERNATIONAL EXPANSION

We therefore require an internationally coordinated economic policy which addresses the situation in both the large, strong economies and the small and weak ones. With respect to the former, every effort must be made through existing diplomatic channels and international organizations (such as the OECD) to persuade the Germans and Japanese to pursue fiscal, monetary and exchange rate policies which allow for more rapid expansion of imports. These policies must lead to foreign sector deficits for them which provide more stimulus to exports in the rest of the world and alleviate the balance of payments and debt problems of the debtor countries. The German and Japanese economies are now too large to avoid sharing the responsibility for international economic leadership.

With respect to the weaker economies, policies should be undertaken which will make the debt problem more manageable and thereby allow these countries, taken as a whole, to maintain a larger capacity to import. *The United States must examine its foreign assistance policies and its relationship to international financial institutions in terms of their support for world economic recovery.* Policymakers must recognize the close relationship between these "international" decisions—many of which will come before Congress in 1977—and the more press-

ing domestic considerations of unemployment, inflation, and the Federal budget. Financial assistance to the weaker economies must also be coordinated among the stronger economies and between them and OPEC. *U.S. contributions to the international financial institutions should be matched several times over by the other countries that can afford to do so.*

POLICY CHANGES REQUIRED

Countries that have borrowed to make productive investments will be able to pay off their debts and should continue to borrow commercially. *Mechanisms should be designed to complement and support commercial bank lending, rather than to substitute for it.* Effective management of the debt problem, however, will require a reduction in the foreign sector deficits of some non-OPEC countries where policies have been inappropriate. Countries that have borrowed to finance consumption or public services will have to make corrective policy changes which redirect their borrowed resources to productive investment. Expanded technical assistance to the developing countries may be needed to increase the chance that investments will be made wisely. *An internationally coordinated policy that directed investment to energy production and conservation would meet the short-term problem of increasing economic demand and also address the world's longer term energy problems.*

International debt management policies must not destroy incentives for needed adjustments in the weak economies. But the pace and timing of adjustments are crucial, and additional mechanisms are required to provide temporary financing to countries committed to adjustment policies. *The danger is that too much adjustment will be forced upon too many countries too quickly.* Widespread efforts to eliminate many foreign sector deficits simultaneously will be self-defeating. Everyone cannot reduce his foreign sector deficit; to avoid world contraction, someone must borrow and spend the OPEC surplus. We need to ensure that this can be accomplished without destabilizing and contracting the international economy and our own.

This coordinated policy solution is illustrated in the projection of Table 4, which assumes enough increased stimulus in Germany and Japan, and enough additional financial assistance to the debtor countries, to raise economic growth in the non-U.S. OECD countries to 4½ percent in 1977 and 5½ percent in 1978. This higher world growth would lead to a somewhat larger OPEC surplus than under the domestic policy option of Table 3, and the financial assistance provided to the weaker economies would allow them to reduce their aggregate foreign sector deficits at a somewhat slower rate, although this would be mitigated by their stronger export performance. Germany and Japan, in providing more fiscal and monetary stimulus, would have lower foreign sector balances. Less U.S. fiscal stimulus would be necessary and the budget deficit would fall as the economy improved. Thus our domestic growth and employment targets could be met with a diminishing budget deficit in 1978 and beyond.

TABLE 4.—COORDINATED POLICY OPTION

[In billions of dollars]

	1976	1977	1978
Foreign sector balances:[1]			
OPEC surplus[2]	40	45	45
Developing countries[3]	−30	−29	−28
Developed countries[4]	−10	−16	−17
United States	2	−2	−5
Germany and Japan	11	5	0
Other developed countries	−23	−19	−12
Sino-Soviet bloc and statistical discrepancy[5]	0	0	0
Results for U.S. economy:			
Net exports (NIA)[6]	7	3	0
Real export growth (annual rate)[7] (percent)	4.7	5.5	6.5
Real GNP growth (annual rate)[7] (percent)	5.3	6.0	6.0
Unemployment rate[8] (percent)	8.0	7.0	6.0

1 Balances on goods, services, and private transfers.

2 Includes Oman, which is not a member of OPEC. The projection assumes an oil price increase of 5–10 percent at the beginning of 1977 and a similar increase at the beginning of 1978. It also assumes 1976 OPEC sales of 10.3 billion barrels at a price of $11.50 per barrel. OPEC is taken to be the residual supplier of energy to the world market in 1977 and 1978. Total energy demands, and supplies from non-OPEC sources, have been projected on the basis of estimates made by international organizations, private agencies, and private banks. OPEC imports are assumed to grow at 15 to 18 percent annually in 1977 and 1978, depending on the growth of OPEC export revenues.

3 Includes all countries except developed countries (see below), OPEC and the Sino-Soviet bloc.

4 OECD plus South Africa, Israel, Yugoslavia, Cyprus, and Malta.

5 The statistical discrepancy varies widely from year to year. It depends upon statistical coverages and lags in reporting various trade and financial flows. There is roughly a balance between the current account deficit of the Sino-Soviet bloc and the positive statistical discrepancy, however, so the net balance of the two is projected here as zero.

6 Net exports (NIA) differ from the current account balance in that they exclude private transfers and interest paid: foreigners on U.S. Government debt. These items add approximately $5 billion to the current account deficit.

7 4th quarter over 4th quarter rates estimated from the OECD 1977 forecast of semi-annual rates and the assumed 1978 rates described in the text.

8 4th quarter. Calculated on the assumption that 3½ percent real growth is required to hold the unemployment rate constant, and that for each 1 percent deviation from 3½ percent growth the unemployment rate will change by 0.4 percent per year.

The coordinated policy option would have a further international advantage in that it would increase the lending of real resources by OPEC to the developing countries, rather than to Germany, Japan, and the United States, whether this was done through official or commercial bank channels. The domestic policy option outlined in Table 3 would have the anomalous result of transferring fewer real resources to the developing countries and more to the United States. Because their imports would be reduced, the developing countries would be borrowing fewer goods and services, and the United States, with a large foreign sector deficit, would be borrowing more. The coordinated policy option makes especially good sense as long as resources remain underemployed in the United States. At the present time, goods borrowed by the poorer countries for development would otherwise remain unused. OPEC finance for fertilizer plants in Bangladesh makes more sense than purchases of Treasury bills or Swiss bank deposits. *In other words, everyone can gain if U.S. employment rises to produce exports to developing countries.*

The task of policy coordination will not be easy, either internationally or nationally. International mechanisms for effective policy coordination have only begun to develop, although institutions such as the OECD, IMF and World Bank provide organizational structures for the purpose. The United States has its own institutional problems, since the policies of the Administration, the Congress, and the Federal Reserve must themselves be coordinated before international coordination can be achieved. But the costs of *not* coordinating policies will be very high—for the U.S. economy, for the Federal budget, and for international recovery and stability.

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